

I. INTRODUCTION

Mortgage derivative products include Collateralized Mortgage Obligations (CMOs), Real Estate Mortgage Investment Conduits (REMICs), CMO and REMIC residuals, and Stripped Mortgage Backed Securities (SMBSs). The cash flows from the mortgages underlying these securities are redirected to create two or more classes with different maturity or risk characteristics designed to meet a variety of investor needs and preferences.

Some mortgage derivative products exhibit considerably more price volatility than mortgages or ordinary mortgage pass-through securities and can expose investors to significant risk of loss if not managed in a safe and sound manner. This price volatility is caused in part by the uncertain cash flows that result from the prepayment rates of the underlying mortgages.

Because these products are complex, a high degree of technical expertise is required to understand how their prices and cash flows behave in various interest rate and prepayment environments. Moreover, because the secondary market for some of these products is relatively thin, they may be difficult to liquidate should the need arise. Finally, there is additional uncertainty because new variants of these instruments continue to be introduced, and their price performance under varying market and economic conditions has not been tested.

Definitions

Collateralized Mortgage Obligations (CMOs) are bonds collateralized with mortgage loans or mortgage-backed securities. The cash flows from the mortgages underlying these securities are redirected to create two or more classes or tranches with different coupon rates, maturity dates, payment frequencies, and interest rate risk characteristics. The purchasers of these tranches receive cash flows in a predetermined order such that one tranche holder may receive principal and interest cash flows while a holder of a different tranche may receive only interest payments until other tranches have paid out. The timing of these principal payments to the bondholders may be extremely sensitive to changes in interest rates.

Real Estate Mortgage Investment Conduits (REMICs) issue multi-tranched mortgage

securities. The REMIC is a federally tax-exempt entity that has been used exclusively since August 1992 to issue multi-tranched mortgage securities including CMOs. All tranches publicly issued by a REMIC are in bond form.

Stripped mortgage-backed securities (SMBSs) are securities created by reallocating the principal and interest cash flows of underlying mortgages on a disproportionate basis to form two separate securities. In their purest form, SMBSs may be issued as interest-only strips (IOs) and principal-only strips (POs).

PO strips offer the investor the principal cash flows of the underlying mortgages and are normally purchased at a discount. Agency securities which have been stripped (FNMA, FHLMC, and GNMA) continue to carry the respective Agency's guarantee of timely payment of principal and interest. The cash flows of PO strips are extremely sensitive to changes in interest rates, thus the average lives and prices of these securities are volatile. Generally, as interest rates rise, the market value of PO strips will decrease as the investor receives smaller amounts of principal payments over a longer period of time until total principal is returned. If interest rates decline, the market value of PO strips generally increases as the investor receives greater amounts of principal over a shorter period of time until total principal is returned.

IO strips offer the investor the interest cash flows of the underlying mortgages and are purchased at a price based on the present value of the estimated interest cash flows over the life of the security. There is no principal or par amount purchased by the investor. The cash flow received by the investor is the interest based on the outstanding principal balance of the underlying mortgages. Thus, as interest rates decline and prepayments increase, interest cash flow received decreases due to a decrease in the outstanding principal balance, and the market value of the IO strip generally decreases. As interest rates increase and prepayments decrease, the interest cash flow is received by the investor for a longer period of time, generally resulting in an increase in the market value of the IO strip.

A CMO or REMIC residual is a security issued with no amount or a nominal amount of principal and is purchased at a price based on the present value of the estimated cash flows generated by the

underlying collateral. The primary source of this cash flow is the coupon differential between the weighted average coupon rate on the underlying collateral and the weighted average coupon rate of all tranches or debt classes. The residual investor also receives any excess cash flows not needed to service the debt of the CMO or the REMIC. The cash flows are extremely sensitive to changes in interest rates, and there is a risk that if prepayments occur at a faster rate than anticipated, the investor may lose part of the original investment.

II. SUPERVISORY TREATMENT

Mortgage derivative products purchased prior to February 10, 1992, will be reviewed in accordance with the FDIC's previously existing policies. Securities purchased after February 10, 1992, will be reviewed in accordance with the FDIC's Policy on Securities Activities.

Purchases Prior to February 10, 1992

Mortgage derivative products purchased prior to February 10, 1992, should be classified according to the chart in Exhibit 1 at the end of this section.

CMO tranches with characteristics similar to IO strips, PO strips or residuals should be classified accordingly. Tranches that exhibit volatile average life and price characteristics may be criticized and classified based on the judgement of the examiner. Those classifications are summarized below.

1. Held-for-Investment

Mortgage derivative products that are purchased and retained by an institution as a tool for managing interest rate risk and the institution has the intent and the ability to hold them until maturity, would be categorized as held for investment and reported on the financial statements at amortized cost.

For supervisory purposes, absent credit quality problems with the issuer and/or underlying mortgages, mortgage derivative products that are found to meet the standards discussed for managing interest rate risk (or that are held in an aggregate amount that the examiner considers so small as to be insignificant to the institution)

would not be adversely classified.

PO strips are generally considered unsuitable for an institution to hold for investment because of their price volatility resulting from the sensitivity of their cash flows to changes in interest rates and mortgage prepayment rates. Nevertheless, absent credit quality problems, these securities should provide full recovery of the initial investment over time. For that reason, their unsuitability as investments generally should be addressed in the examination report. However, when reviewing PO strips that are not issued by, or are not backed by loans that are fully guaranteed by a federal agency, the credit quality of the underlying mortgages and the private (non-governmental) issuer must be considered. Where any doubt about credit quality exists for a particular PO issue, the examiner's judgment based on existing classification procedures for securities should determine the proper classification of the PO strip.

Although the prices of IO strips are also highly volatile as a result of the sensitivity of their cash flows to changes in interest rates and mortgage prepayment rates, there is no assurance that any return will be forthcoming from this investment or that the amount of an initial investment in these securities will be fully recoverable. For that reason, notwithstanding the credit quality of the underlying mortgages, all IO strips held for investment not meeting the standards discussed herein, whether issued by a federal agency or by a private (non-governmental) entity, should be treated as subinvestment quality securities. Thus, depreciation in these securities should be classified Doubtful and the remaining book value of these securities should be classified Substandard.

In contrast, residuals may be considered the ownership interest in, rather than direct obligations of, the related collateralized mortgage obligation (CMO) trust and are considered "other assets," not securities, for regulatory reporting purposes. Those residuals held for investment not meeting those standards/qualifications as a tool to manage interest rate risk should also be considered subinvestment quality assets. Since some of these instruments have equity characteristics, their supervisory treatment should be consistent with that currently accorded subinvestment quality stocks. Hence, any excess book value over market value for a subinvestment

quality residual should be classified Loss with the remaining book value classified Substandard.

Besides the pure IO and PO strips, stripped mortgage-backed securities with different combinations of cash flows and other mortgage derivative securities with characteristics similar to IO and PO strips (including certain CMO tranches) have been issued. For supervisory purposes, such instruments must be reviewed on an individual basis. Some fractional combinations of mortgage derivative securities may be set up to provide high percentages of either the principal or interest cash flows from the underlying mortgages with only a minimal amount of the other element, i.e., 96% of the interest cash flows and 4% of the principal, or 99% of the principal cash flows and 1% of the interest. Fractional combinations structured in such a manner are, in effect, an IO or PO strip. Thus, these types of fractional combinations and all other securities with essentially the same characteristics as IO and PO strips (including certain CMO tranches) should be treated in the same manner as an IO or PO strip for supervisory purposes.

Nevertheless, some fractional combinations are much more balanced in terms of the cash flows allocated to them, such as 55% of the principal cash flows and 45% of the interest, and more closely resemble a traditional pass-through mortgage-backed security. Depending upon the credit quality of the issuer and/or the underlying mortgages, it is not appropriate to treat these more balanced issues any differently than other mortgage-backed securities of comparable quality. Thus, each examiner must use his/her judgment to determine whether or not to comment on or adversely classify fractional combinations of mortgage derivative securities held for investment.

This judgment will depend upon the nature of the cash flows the holder will receive as prepayment rates change in various interest rate environments, the possible price volatility of the securities based on the expected cash flows, and the creditworthiness of the issuer of each security and the mortgage collateral.

2. Available-for-Sale

Securities that are intended to be sold at some point during an indefinite future period of time are considered to be available-for-sale by the

institution and should be reported on the financial statements at the lower of cost or market value. Any unrealized loss on securities held for sale (aggregate cost in excess of aggregate market value) or increase in a previously recorded unrealized loss should be credited to a valuation allowance with an offsetting charge to expense included in the determination of net income for the period. Any decrease in a previously recorded unrealized loss would reduce the valuation allowance and be included in net income for the period.

Securities available for sale would include any mortgage derivative product that the institution has committed to sell as a result of their previously being deemed unsuitable investments for the institution as well as any other securities (or mortgages) not acquired for trading that the institution intends to sell in the future.

For examination report purposes, securities held for sale (net of any valuation allowances) should be included on the Statement of Financial Condition as Available-for-Sale Securities. On the Liquidity and Dependency Ratios schedule, available-for-sale securities should be included as securities maturing in one year or less with the net amount noted in the footnote section of the schedule. However, if the examiner has reason to believe that the institution under examination is unlikely to sell the securities within one year, these securities should be reported on the Liquidity and Dependency Ratios schedule as other marketable assets with the net amount noted in the footnote section.

Furthermore, if, as of the asset review date, an institution holds PO strips for sale in an amount that is deemed unsuitable, then the institution's holdings should be criticized because of their effect on interest rate risk, liquidity, earnings, etc. Any individual PO strip security available-for-sale that is determined to be of subinvestment quality would be adversely classified. Consistent with the accounting standards applicable to securities available-for-sale, any depreciation in subinvestment quality PO strips should be classified Loss and the remaining book value should be classified Substandard. Likewise, to the extent that the net depreciation as of the asset review date in PO strips available-for-sale (excluding any of subinvestment quality) exceeds the institution's lower of cost or market valuation allowance for that type of security as of

examination as of date, such additional depreciation should be classified Loss. However, examiner insistence for immediate charge-off of such a lower of cost or market Loss classification is not necessary if the institution adjusts its valuation allowances for securities available-for-sale through charges to expense at least quarterly.

Similarly, if, as of the asset review date, an institution holds for sale IO strips or residuals that are deemed unsuitable investments, those securities should be treated as subinvestment quality assets. As above, any depreciation in subinvestment quality IO strips and residuals should be classified Loss and the remaining book value should be classified Substandard.

3. Held-for-Trading

Any mortgage derivative product the institution has acquired with the intent to resell in the near future in order to profit from changes in the interest rate environment should be included in this account. For supervisory purposes, absent credit quality problems, mortgage derivative products designated by management as trading account assets need not be adversely classified if the appropriate management policies and internal controls are established and maintained for the institution's trading activities. Otherwise, for examination report purposes, mortgage derivative products designated as (or determined by the examiner to be) trading account assets should be classified in a manner similar to that described above for securities available-for-sale. In this regard, consistent with the applicable accounting standards for trading accounts, any net unrealized losses on PO strips at the date of the asset review (excluding any of subinvestment quality) should be classified Loss. However, examiner insistence for immediate charge-off of the amount classified Loss is not necessary if the institution marks its trading account securities to market value at least monthly with unrealized gains and losses recognized in current income.

In addition, when adequate controls over and policies governing the institution's trading activities are not in place, the examiner should recommend that trading activities be discontinued while the institution's board of directors determines whether such activities are appropriate for the institution. If the directors so determine, appropriate controls and policies

should be instituted prior to the resumption of trading activities.

Purchases After February 10, 1992

A general principal underlying this policy is that mortgage derivative products possessing average life or price volatility in excess of a benchmark fixed rate 30-year mortgage-backed pass-through security are "high-risk mortgage securities" and are not suitable investments. All high-risk mortgage securities, as defined in detail later in this section, acquired by financial institutions after February 10, 1992, must be carried in the institution's trading account or as assets available-for-sale. On the other hand, mortgage derivative products that do not meet the definition of a high-risk mortgage security at the time of purchase should be reported as held-to-maturity investments, available-for-sale assets, or trading assets, as appropriate. Institutions must ascertain no less frequently than annually that such products remain outside the high-risk category.

Institutions that hold mortgage derivative products that meet the definition of a high-risk mortgage security must do so to reduce interest rate risk in accordance with safe and sound practices. Furthermore, financial institutions that purchase high-risk mortgage securities must demonstrate that they understand and are effectively managing the risks associated with these instruments. Levels of activity involving high-risk mortgage securities should be reasonably related to an institution's capital, capacity to absorb losses, and level of in-house management sophistication and expertise. Appropriate managerial and financial controls must be in place, and the institution must analyze, monitor, and prudently adjust its holdings of high-risk mortgage securities in an environment of changing price and maturity expectations.

Notwithstanding the provisions of this section requiring the use of high-risk mortgage securities to reduce interest rate risk, this supervisory policy is not meant to preclude an institution with strong capital and earnings and adequate liquidity that has a closely supervised trading department from acquiring high-risk mortgage securities for trading purposes. The trading department must operate in conformance with well-developed policies, procedures, and internal controls, including detailed plans prescribing specific position limits and control arrangements for enforcing these

limits.

Prior to taking a position in any high-risk mortgage security, an institution should conduct an analysis to ensure that the position will reduce the institution's overall interest rate risk. An institution should also consider the liquidity and price volatility of these products prior to purchasing them. Circumstances in which the purchase or retention of high-risk mortgage securities is deemed by the FDIC to be contrary to safe and sound practices for financial institutions will result in criticism by examiners, who may require the orderly divestiture of high-risk mortgage securities. Suggested classifications of mortgage derivative products purchased after February 10, 1992 are included as Exhibit 2 at the end of this section.

Securities and other products, whether carried on or off the balance sheet (such as CMO swaps, but excluding servicing assets), having risk characteristics similar to high-risk mortgage securities will be subject to the same supervisory treatment as high-risk mortgage securities.

Definition of "High-Risk Mortgage Security"

Prior to purchase, management must determine whether the mortgage derivative product is a high-risk mortgage security. A high-risk mortgage security is defined as any mortgage derivative product that at the time of purchase, or at a subsequent testing date, meets any one of the following tests. Note that only mortgage derivative products are subject to the tests; standard fixed rate mortgage-backed pass-through securities are not covered by the definition of a high-risk mortgage security in the Policy Statement.

1. Average Life Test.

The mortgage derivative product has an expected weighted average life greater than 10 years.

Weighted average life is the dollar-weighted average time in which principal is repaid. Weighted average life is computed by a) multiplying the amount of each principal reduction by the number of years or months from the date of issuance or current testing date to the date of such reduction, b) summing the results, and c) dividing the sum by the remaining principal balance as of the test date. Weighted average life

is not equivalent to contractual maturity or expected final maturity.

In order to conduct the Average Life Test, the cash flows of the instrument must be estimated based on the prepayment assumption associated with the underlying collateral. This prepayment assumption must be reasonable and its source documented for examiner review.

Examiners should request a copy of the prospectus supplement and other supporting analysis that fully details the characteristics of the underlying collateral and cash flows of the security. The examiner should then compare the prepayment assumption used in the Average Life Test with the median prepayment assumption of several major dealers for the underlying collateral. If the prepayment assumption utilized differs significantly from the median prepayment assumption of several major dealers, examiners should request documentation supporting the use of the prepayment rate and may require that the test be conducted using an average of the prepayment assumptions of major dealers.

Prepayment assumptions for Agency issued mortgage-backed pass-throughs are published monthly by major dealers. Examiners should request this information from the institution.

2. Average Life Sensitivity Test.

The expected weighted average life of the mortgage derivative product (a) Extends by more than 4 years, assuming an immediate and sustained parallel shift in the yield curve of plus 300 basis points, or (b) Shortens by more than 6 years, assuming an immediate and sustained parallel shift in the yield curve of minus 300 basis points. The test requires the use of prepayment assumptions associated with the underlying collateral given an immediate and sustained parallel shift in the yield curve of plus and minus 300 basis points in increments of 100 basis points. Examiners should request documentation of the source of the prepayment assumptions used and determine the reasonableness of the assumptions. Again, major dealers publish prepayment assumptions assuming changes in interest rates, and examiners may use these dealer projections as a guide in assessing the appropriateness of the institution's prepayment assumptions.

A mortgage derivative product that meets the definition of a high-risk security at any incremental shift in the yield curve will be deemed to be high-risk. Thus, a security that meets the high-risk definition given a 200 basis point increase in interest rates, but does not meet the definition given a 300 basis point increase, will still be deemed to be high-risk.

3. Price Sensitivity Tests.

The estimated change in the price of the mortgage derivative product is more than 17 percent, due to an immediate and sustained parallel shift in the yield curve of plus or minus 300 basis points or any 100 basis point increment up to 300 basis points.

The same prepayment assumptions and cash flows that were used to calculate Average Life Sensitivity must be used in this test. The only additional assumption needed for this test is a discount rate assumption. An acceptable method for estimating the change in the price of a mortgage derivative product is as follows:

1. Assume that the discount rate for the instrument equals the yield on a comparable average life U.S. Treasury security plus a constant spread.
2. Calculate the spread over Treasury rates from the bid side of the market for the mortgage derivative product.
3. Assume the spread remains constant when the Treasury curve shifts up or down 300 basis points in increments of 100 basis points.

Other methods for computing the price sensitivity may be acceptable. Documentation of the assumptions and methodology for computing the price must be maintained and available for examiner review.

Examiners should verify that the prepayment assumptions for the +/- 300 basis point changes in interest rates are identical to the prepayment assumptions used in the Average Life Sensitivity Test. Examiners should also confirm that the price computations were based on immediate and sustained parallel shifts in the yield curve by requesting all test documentation including sources of bid/ask prices and the yield curve as of

the test date. If the examiner determines that one or more of the assumptions and/or calculations are inappropriate, the examiner may require the institution to retest the mortgage derivative product using the assumptions and/or calculations specified in the Policy Statement.

Exceptions

Generally, a CMO floating rate debt class will not be subject to the average life and average life sensitivity tests if it bears a rate that, at the time of purchase or at a subsequent testing date, is below the contractual cap on the instrument. (An institution may purchase interest rate contracts that effectively uncapped the instrument.) For purposes of this policy statement, a CMO floating rate debt class is a debt class whose rate adjusts at least annually on a one-for-one basis with the debt class's index. The index must be a conventional, widely-used market interest rate index such as the London Interbank Offered Rate (LIBOR). Inverse floating rate debt classes are not exempt from any of the tests.

Floating rate debt classes with coupon rates tied to indices other than LIBOR, are generally exempt from the average life and average life sensitivity tests. However, due to the price volatility associated with these securities, institutions that purchase non-LIBOR indexed floaters must maintain documentation demonstrating that the risks of these instruments are understood and monitored. The documentation should include a comprehensive pre-purchase analysis and, at a minimum, an annual analysis of the price sensitivity of the instrument under both a plus and minus 300 basis point (in increments of 100 basis points) parallel and nonparallel shift in the yield curve. The effect of an interest rate CAP on the price of the floater should also be analyzed and documented. All analyses must be available for examiner review.

When the characteristics of a mortgage derivative product are such that the first two tests cannot be applied (such as with IOs), the mortgage derivative product remains subject to the third test (Price Sensitivity Test).

Test Examples

Examples of the Average Life, Average Life Sensitivity, and Price Sensitivity Tests for a CMO/REMIC tranches are included as Exhibit 3 at

the end of this section.

Interest Rate Risk Reduction Analysis

Management must document and demonstrate prior to purchase and quarterly thereafter, that either the yield performance or cash flow of the high-risk mortgage security is reducing both the interest rate risk of the designated group of assets or liabilities and the interest rate risk of the institution as a whole.

In applying any of the above tests, all of the underlying assumptions (including prepayment assumptions) for the underlying collateral must be reasonable. All of the assumptions underlying the analysis must be available for examiner review. For example, if an institution's prepayment assumptions differ significantly from the median prepayment assumptions of several major dealers as selected by examiners, the examiners may use the median prepayment assumption in determining if a particular mortgage derivative product is high risk.

The above tests may be adjusted in the event of a significant movement in market interest rates or to fairly measure the risk characteristics of new mortgage-backed products. Furthermore, the FDIC reserves the right to take such action as it deems appropriate to prevent circumvention of the definition of a high-risk mortgage security and other standards set forth in this section.

III. SUPERVISORY POLICY FOR MORTGAGE DERIVATIVE PRODUCTS

Supervisory Policy. Institutions that have purchased mortgage derivative products prior to or after February 10, 1992, should have the following documentation, completed prior to and/or subsequent to purchase where appropriate, available for examiner review.

1. A board-approved portfolio policy which addresses the goals and objectives the institution expects to achieve through its securities activities, including interest rate risk reduction objectives with respect to mortgage derivative products;
2. Limits on the amount of funds that may be committed to mortgage derivative products;
3. Specific financial officer responsibility for and authority over securities activities involving mortgage derivative products;
4. Adequate information systems;
5. Procedures for periodic evaluation of mortgage derivative products and their actual performance in reducing interest rate risk; and
6. Appropriate internal controls.

Examiners should also request documentation of an interest rate risk sensitivity analysis developed prior to purchase and updated throughout the life of the instrument. Such documentation should include interest rate risk sensitivity analysis that illustrates the impact of changes in interest rates, in 100 basis point increments to at least plus and minus 300 basis points, on the cash flows or yield or the average life and price of the mortgage derivative product. This analysis should be documented and approved by the board of directors or by an appropriate committee.

Circumstances in which the purchase or retention of any mortgage derivative product is deemed by the FDIC to be contrary to safe and sound practices for financial institutions will result in criticism by examiners, who may require the orderly divestiture of the mortgage derivative product.

Prior to purchase, a financial institution must determine whether a mortgage derivative product is high-risk, as defined above. A prospectus supplement or other supporting analysis that fully details the cash flows covering each of the securities held by the institution should be obtained and analyzed prior to purchase and retained for examiner review. In any event, a prospectus supplement should be obtained as soon as it becomes available.

Nonhigh-Risk Mortgage Securities

Mortgage derivative products that do not meet the definition of high-risk mortgage securities at the time of purchase should be reported as held-to-

maturity investments, available-for-sale assets, or trading assets, as appropriate. Institutions must ascertain and document prior to purchase and no less frequently than annually thereafter, that nonhigh-risk mortgage securities that are held for investment remain outside the high-risk category. If an institution is unable to make these determinations through internal analysis, it must use information derived from a source that is independent of the party from whom the product is being purchased. Standard industry calculators used in the mortgage-related securities marketplace are acceptable and are considered independent sources. In order to rely on such independent analysis, institutions are responsible for ensuring that the assumptions underlying the analysis and the resulting calculations are reasonable. Such documentation will be subject to examiner review.

A mortgage derivative product that was nonhigh-risk at purchase and is designated as held-to-maturity may later become high risk. As indicated by the FFIEC interim revision to its policy statement, such a security will not be subject to redesignation as available-for-sale or trading if the institution can continue to demonstrate a positive intent and ability to hold the security to maturity. However, examiners should consider any unrealized net depreciation in held-to-maturity high-risk mortgage derivative products in the evaluation of an institution's capital adequacy. This evaluation should also include the effects that changes in interest rates will have on the amount of unrealized net depreciation in held-to-maturity high-risk mortgage derivative products. In addition, high-risk mortgage derivative products designated as held-to-maturity securities should be used to reduce interest rate risk and those that have risk of loss of principal or book value, and are not held for purposes of interest rate risk reduction, may be classified in accordance with the guidelines in Exhibit 2.

Once a mortgage derivative product has been designated as high-risk, it may be redesignated as non-high-risk only if, at the end of two consecutive quarters, it does not meet the definition of a high-risk mortgage security. Upon redesignation as a nonhigh-risk security, it does not need to be tested for another year. There is no provision for excluding mortgage derivative products from the high-risk designation once an analysis of the mortgage derivative product indicates that it should be treated as high-risk. Thus, non-high-risk securities that are tested more frequently than annually should be redesignated as high-risk on any test date if the security fails any of the three tests.

The balances of available-for-sale and trading securities scheduled for classification in examination reports should be shown at the fair value amounts at which they are reported on the balance sheet. Only the amount, if any, of unrealized losses (i.e., depreciation) since the institution's most recent fair value adjustments to the balance sheet carrying values of available-for-sale and trading securities should be scheduled as Loss. However, because unrealized gains and losses on available-for-sale debt securities are not included in regulatory (i.e., Tier 1) capital, the entire amount of unrealized losses on adversely classified available-for-sale securities (and not just any amounts scheduled as Loss) must be deducted from Tier 1 capital before calculating regulatory capital ratios. No such adjustment to regulatory capital calculations is necessary for trading securities, as unrealized gains and losses on trading securities are included in an institution's earnings.

High-Risk Mortgage Securities

An institution may only acquire a high-risk mortgage derivative product to reduce its overall interest rate risk. (Institutions with acceptable trading departments may also purchase these securities for trading purposes.) An institution that has acquired high-risk mortgage securities to reduce interest rate risk needs to manage its holdings of these securities because of their substantial prepayment and average life variability. Such management implies that the institution does not have both the intent and the ability to hold high-risk mortgage securities for long-term investment purposes. Accordingly, high-risk mortgage securities that are being used to reduce interest rate risk should not be reported as investments at amortized cost, but must be reported as trading assets at market value or as available-for-sale assets at the lower of cost or market value.

An institution that owns or plans to acquire high-risk mortgage securities must have a monitoring system in place to evaluate the expected and actual performance of such securities. The institution must conduct an analysis that shows that the proposed acquisition of a high-risk mortgage security will reduce the institution's overall interest rate risk. Subsequent to purchase, the institution must evaluate whether this high-risk mortgage security has actually reduced interest rate risk.

The institution's analyses performed prior to the purchase of high-risk mortgage securities and subsequently thereafter must be fully documented and will be subject to examiner review. This review will include an analysis of all assumptions used by management regarding the interest rate risk associated with the institution's assets, liabilities, and off-balance sheet positions. Analyses performed and records constructed to justify purchases on a post-acquisition basis are unacceptable and will be subject to examiner criticism. Reliance on analyses and documentation obtained from a securities dealer or other outside party without internal analyses by the institution are unacceptable and reliance on such third-party analyses will be subject to examiner criticism.

Additionally, examiners should note that while not all high-risk mortgage derivative products purchased after February 10, 1992, will be subject to adverse classification, examiners may continue to seek divestiture of high-risk mortgage derivative products that do not reduce interest rate risk when determined that continued ownership of these securities represents an undue safety and soundness risk to the institution. This risk can arise from the size of an institution's holding of high-risk mortgage derivative products in relation to its capital and earnings, management's inability to demonstrate an understanding of the nature of the risks inherent in these securities, the absence of internal monitoring systems and other internal controls to appropriately measure the market and cash flow risks of these securities, management's inability to prudently manage its overall interest rate risk, or other similar factors. Those securities must be reported as available-for-sale assets at the lower of cost or market value.

Other Requirements

Management should also maintain documentation demonstrating that it took reasonable steps to assure that the prices paid for high-risk mortgage securities represented fair market value. Generally, price quotes should be obtained from at least two brokers prior to executing a trade. If, because of the unique or proprietary nature of the transaction or product, or for other legitimate reasons, price quotes cannot be obtained from more than one broker, management should document the reasons for not obtaining such quotes.

Several states have adopted regulations that prohibit state-chartered banks from purchasing interest-only strips or other securities discussed above. Accordingly, state-chartered institutions should consult with their state regulator concerning the permissibility of these purchases.

In addition, a depository institution that owns high-risk mortgage securities must demonstrate that it has established the following:

1. A board-approved portfolio policy which addresses the goals and objectives the institution expects to achieve through its securities activities, including interest rate risk reduction objectives with respect to high-risk mortgage securities;
2. Limits on the amount of funds that may be committed to high-risk mortgage securities;
3. Specific financial officer responsibility for and authority over securities activities involving high-risk mortgage securities;
4. Adequate information systems;
5. Procedures for periodic evaluation of high-risk mortgage securities and their actual performance in reducing interest rate risk; and
6. Appropriate internal controls.

The board of directors, or an appropriate committee thereof, and the institution's senior management should regularly (at least quarterly) review all high-risk mortgage securities to determine whether these instruments are adequately satisfying the interest rate risk reduction objectives set forth in the portfolio policy. The financial institution's senior management should be fully knowledgeable about the risks associated with prepayments and their subsequent impact on its high-risk mortgage securities.

Failure to comply with this policy will be viewed as an unsafe and unsound practice.

Purchases of high-risk mortgage securities prior to February 10, 1992, generally will be reviewed in accordance with previously-existing supervisory policies. Securities and other products, whether

carried on or off the balance sheet (such as CMO swaps, but excluding servicing assets), having characteristics similar to those of high-risk mortgage securities will be subject to the same supervisory treatment as high-risk mortgage securities.

EXHIBIT 1
Suggested Classifications of Mortgage Derivative Products Purchased
Prior to February 10, 1992 And Long-Term Zero Coupon Bonds

	<u>Held-to-Maturity</u>		<u>Available-for-Sale</u>		<u>Trading (3)</u>	
	<u>Used for IRR Reduction</u>	<u>All Others</u>	<u>Used for IRR Reduction</u>	<u>All Others</u>	<u>Meets Criteria Of Policy Statement(4)</u>	<u>Does Not Meet Criteria of Policy State- ment (5)</u>
POs Investment Quality	None	None	None	None	None (Unrealized loss classified Loss)	None (Unrealized loss classified Loss)
Subinvest- ment Quality (1)	MV - Sub. Dep. - Doubt.	MV - Sub. Dep. - Doubt.	MV - Sub. Dep. - Doubt.	MV - Sub. Dep. - Doubt.	MV - Sub. Unrealized loss classified Loss	MV - Sub. Unrealized loss classified Loss
los (1)	None	MV - Sub. Dep. - Doubt.	None	MV - Sub. Dep. - Doubt.	None (Unrealized loss classified Loss)	MV - Sub. Unrealized loss classified Loss
Residuals (1)	None	MV - Sub. Dep. - Loss	None	MV - Sub. Dep. - Loss(3)	None (Unrealized loss classified Loss)	MV - Sub. Unrealized loss classified Loss
CMO/REMIC (2) Tranches (1)	None	MV - Sub. Dep. Doubt.	None None	MV - Sub. Dep. - Doubt.	None (Unrealized loss classified Loss)	MV - Sub. Unrealized loss classified loss
Large Positions in Long-Term Zero Coupons						
Investment Quality	None	None	None	None	None (Unrealized loss classified Loss)	None (Unrealized loss classified Loss)
Subinvest- ment Quality (1)	MV - Sub. Dep. - Doubt.	MV - Sub. Dep. - Doubt.	MV - Sub. Dep. - Doubt.	MV - Sub. Dep. - Doubt.	MV - Sub. Unrealized loss classified Loss	MV - Sub. Unrealized loss classified Loss

- (1) Credit quality of individual securities must be evaluated, and if warranted, classification may be more severe than indicated above.
- (2) CMO/REMIC tranches with risk of loss of principal or book value may be classified accordingly.
- (3) Only the amount, if any, of unrealized loss since the institutions most recent fair value adjustments should be scheduled as Loss on available-for-sale and trading securities; however, an adjustment to regulatory capital for the entire amount of unrealized loss on available-for-sale securities is required.
- (4) Institutions with strong capital, earnings and adequate liquidity with closely supervised trading departments are not precluded from acquiring high-risk mortgage securities for trading purposes.
- (5) Includes institutions that have inadequate capital, earnings and liquidity and do not have well-supervised trading departments.

EXHIBIT 2
Suggested Classifications of High-Risk Mortgage Securities
Purchased After February 10, 1992

	<u>Held-to-Maturity (2)</u>		<u>Available-for-Sale</u>		<u>Trading (5)</u>	
	<u>Used for IRR</u>	<u>All Others</u>	<u>Used for IRR</u>	<u>All Others</u>	<u>Meets Criteria</u>	<u>Does Not Meet</u>
	<u>Reduction</u>		<u>Reduction</u>		<u>Of Policy</u>	<u>Criteria of</u>
					<u>Statement(3)</u>	<u>Policy State-</u>
						<u>ment (6)</u>
Pos and Securities						
With PO Character-istics(1)	None	None	None	None	None (Unrealized loss classified Loss)	None (Unrealized loss classified Loss)
los and Securities						
With IO Character-istics(1)	None	MV - Sub. Dep. - Loss	None	MV - Sub. Dep. - Loss(5)	None (Unrealized loss classified Loss)	MV - Sub. Unrealized loss classified Loss
Residuals (1)	None	MV - Sub. Dep. - Loss	None	MV - Sub. Dep. - Loss(5)	None (Unrealized loss classified Loss)	MV - Sub. Unrealized loss classified Loss
All Other (4) High-Risk Mortgage Derivative Sec.	None	BV - Special Mention	None	BV - Special Mention	None (Unrealized loss classified Loss)	None (Unrealized loss classified loss)

- (1) Credit quality of individual securities must be evaluated, and if warranted, classification may be more severe than indicated above.
- (2) All mortgage derivative securities designated as held-to-maturity must be "Nonhigh-Risk" when acquired. Additionally, any mortgage derivatives with risk of loss of principal or book value in the held-to-maturity account which become "High-Risk" after acquisition and are not utilized for reduction of IRR may be classified accordingly.
- (3) Institutions with strong capital and earnings and adequate liquidity with closely supervised trading departments are not precluded from acquiring high-risk mortgage securities for trading purposes.
- (4) Securities held by institutions where management cannot demonstrate and provide adequate documentation to substantiate sufficient knowledge of the risks inherent in high-risk mortgage derivative securities, as well as their effects on the interest rate risk exposure and overall financial condition of the institution, should be listed for Special Mention.
- (5) Only the amount, if any, of unrealized loss since the institution's most recent fair value adjustments should be scheduled as Loss on available-for-sale and trading securities; however, an adjustment to regulatory capital for the entire amount of unrealized loss on available-for-sale securities is required.
- (6) Includes institutions that have inadequate capital, earnings, and liquidity and do not have well-supervised trading departments.

Exhibit 3
Test Example - High Risk Security

Mortgage Derivative Product: CMO/REMIC Support Bond

Test Date: February 10, 1992

Yld Curve Shift	Prepay Speed	Prepay Source	Average Life (yrs.)	Comp. Tsy. Yield	Constant Spread	Security Yield	Bid Price	Ask Price	Price Sensitivity
-300 bp	22.5% CPR	Dealer Model	0.41	1.175%	394 bp	5.115%	100.97		0.0%
0	12.2% CPR	Consensus	1.18	4.126%	394 bp	8.066%	100.59	101.00	
+300 bp	7.5% CPR	Dealer Model	9.71	9.834%	394 bp	13.774%	75.94		-24.8%

Average Life Test:

Maximum Avg. Life	Actual Avg. Life
10.0 years	1.18 years

Average Life Sensitivity Test:

Maximum Shortening	Actual Shortening	Maximum Extension	Actual Extension
6.0 years	0.77 years	4.0 years	8.53 years

Price Sensitivity Test:

Maximum Sensitivity +/-300 bp	Actual Sensitivity +300 bp	Actual Sensitivity - 300 bp
+/- 17%	-24.8%	0.0%

Mortgage Derivative Product is High-Risk Mortgage Security: Tests 2,3

Abbreviations:

REMIC = Real Estate Mortgage Investment Conduit
Yld. = Yield
Comp. = Comparable Average Life
Tsy. = Treasury Security

bp = Basis Points
CPR = Conditional Prepayment Rate
Avg. = Average